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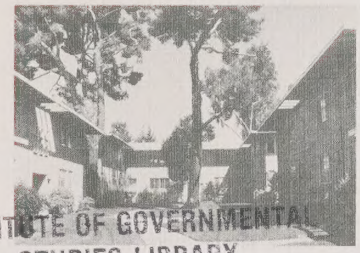

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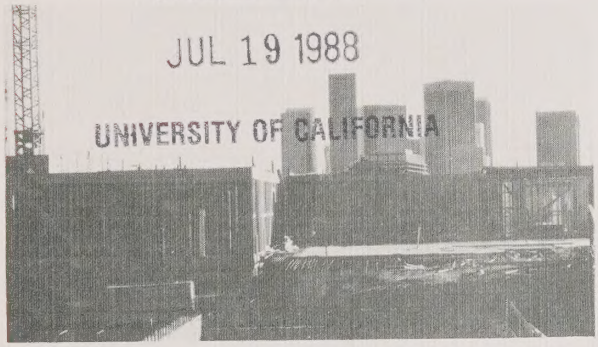

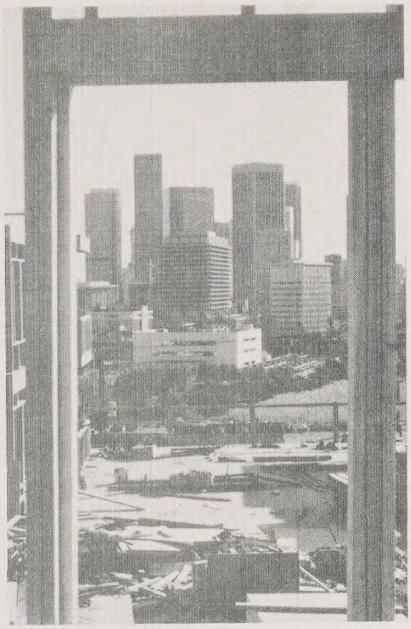

1988 Rent Stabilization Review

EXECUTIVE SUMMARY

Community Development Department
City of Los Angeles

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Exec. Summary

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1988 RENTAL HOUSING REVIEW

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EXECUTIVE SUMMARY

This Report is the second full-scale review of the impact of the Rent Stabilization Ordinance (RSO) and its predecessor rent freeze that was adopted by the Los Angeles City Council a decade ago. The first review was published in 1985, based on data collected late in the previous year. This study is based on a new data base collected in late 1987. It is designed to provide an updated assessment of the impact of the Ordinance after the Council amended it in 1985 to provide for annual ceilings on rent increases that are keyed to the behavior (within a stated floor and cap) of the regional Consumer Price Index (CPI). The study particularly focuses on the effects of the amended Ordinance upon:

* Rent levels and the rent-to-income ratios of tenants.

* The financial situations of building owners.

* The distribution of the benefits and costs of rent stabilization as between tenants and owners, and as between subsets of each group.

* The level of maintenance and reinvestment in the stabilized rental housing market.

* The level of construction of new multi-family housing.

In addition, this study includes special analyses of three issues that have received considerable mention in the current policy debate: (i) the asserted problem of smaller buildings containing concentrations of tenants paying what are termed "historically low rents;" (ii) the impact upon owner finances of major increases in the cost of liability insurance in recent years; and (iii) the tenant demography, rent levels and physical characteristics of the unstabilized stock of rental housing that was first occupied after October 1978.

Key Changes in Backdrop Factors

Although the essentials of the RSO have remained unchanged since the 1985 amendment of the ceiling-setting formula, the demographic and economic environment in the City and the nation have changed considerably. Some of these changes represent continuation of preexisting trends, such as rapid population growth, the shift from migration to births in resident households as the primary driver of that growth, and the simultaneous expansion of both high-tech industries and those which largely employ workers with relatively low levels of education.

Other recent developments represented changes or even reversals in prior trends. Notably:

* The sale market for single-family homes in California recently entered a period which has been described as a "buyers' panic" of a scale unseen since 1979. This has driven average prices for such homes further and further beyond the means of the average renter household.

* Mortgage interest rates fell from an average of 11.7% in the year when data was collected for the first review of RSO impact to 8.8% in 1987.

* Federal tax rules, which formerly contained strong incentives to invest in multi-family housing properties, were amended in 1986 to remove these incentives, thereby decreasing the relative attractiveness of these investments.

* Important new checks on commercial development appeared, as citizens, elected officials and judges wrestled with conflicting pressures to fulfill growing consumer demand and to respond to concerns about further growth.

Key Developments in the Local Rental Housing Market

Influenced by these and other changes in the economic backdrop, some fundamental indicators of tenant and investor behavior underwent substantial change, as revealed in this study:

* Average vacancy rates in the rental stock rose from 3.5% in 1984 to 4.3% in 1987, the highest point they have ever reached since the onset of rent stabilization. This was a sign of an easing but still tight market.

* Tenant mobility, which sharply declined between 1977 and 1984, reversed direction and rose noticeably in 1984-87. Average tenant tenure in a stabilized unit dropped from 5.5 to 4.8 years, and the proportion of tenants that had moved within the prior three years rose from 45% in 1984 to 55% in 1987. Thus, well over half of all the units in the stabilized stock changed hands between the 1984 and 1987 surveys conducted in connection with these reviews.

* The density ratio of people to rooms in stabilized units rose markedly, from an average of .8 persons to .9. Meanwhile, the share of households estimated to be living in overcrowded conditions (i.e., more than one person per room in the unit) rose from 16% to 21%.

* New construction of multi-family housing boomed under the pre-1986 tax rules and with the easing of interest rates, increasing by 531% during 1982-86.

Changing Characteristics of the Renter Population

The new survey of rent stabilized tenant households performed for this review identified a number of important continuities and discontinuities since the last survey:

* An even higher proportion (45%) of Los Angeles tenants did not know in 1987 whether or not their units were subject to rent stabilization (this compares to 41% in 1984).

* The stabilized population continued to be dominated by households of low to moderate income (their average household income was $25,931 and 65% earned less than $30,000 in 1987). Also, their average real income (i.e., income discounted for inflation) fell by about 3% during 1984-87.

* Households headed by members of minority groups became the majority of stabilized households, as the share of White-headed households dropped from 52% in 1984 to 47% in 1987. But the most significant change was in the share of households headed by Hispanics, who increased their proportion by about two-thirds, as the share of Black-headed households declined.

* The age profile of the heads of stabilized households was virtually identical in 1987 as compared with 1984. The average age in 1987 was 42.

* The first data collected on the residents of the unstabilized rental stock occupied since October 1978 revealed a number of interesting contrasts with the 1987 residents of stabilized units:

  # Unstabilized tenant households had 19% higher average incomes than stabilized households ($30,753 as against $25,931). The unstabilized households split evenly between those that earned more than $30,000 and those that earned less.

  # White-headed households were a slim majority (52%) of unstabilized tenants, while Hispanic-headed households comprised approximately the same share of both the stabilized (31%) and the unstabilized (28%) stocks. The second largest minority share of unstabilized units was held by households headed by a member of a non-Hispanic, non-Black minority group, a category which is dominated in numbers by persons of Asian extraction.

  # Unstabilized households were notably younger, on the average, with an average age of 37 for household heads and more than one-third of all heads of unstabilized households under the age of 30.

* Physically, the buildings containing unstabilized units tended to be much larger than those containing stabilized units (a median of 20 units, as against 10), and the unstabilized units themselves tended to have more rooms, especially more bathrooms (only one in five stabilized units had more than one bathroom, whereas two in five unstabilized units had more than one).

Behavior of Average Rents and Rent-to-Income Ratios

The 1987 survey revealed that average stabilized gross rents rose much more slowly during 1984-87 (a compound rate of 5.7% per year) then during 1977-84 (10.9% per year). The average monthly gross rent (i.e., rent plus gas and electricity) paid by a stabilized household was $525 in 1987, compared to $444 in 1984. (Average rents rose at a higher rate than was permitted by the ceiling on increases in the rents charged to non-moving tenants because more than half of all stabilized units were vacated and re-rented between 1984 and 1987, and the rents charged to new tenants could be marked to market by the building owner.)

The average share of the income of a stabilized tenant household consumed by gross rent in 1987 was 29.2%. This was an increase from 28.5% in 1984, reflecting the fact that average rents had increased slightly faster than inflation, while the average income of stabilized households had risen more slowly than inflation. The average share still stayed below the Federal affordability standard of no more than 30% of income devoted to housing, but 38% of all stabilized households paid income shares above this threshold in 1987, and about one-quarter of them paid more than 40% of their incomes in rent.

The demographic distribution of average rents and rent-to-income ratios in 1987 showed much the same basic pattern as in 1984. Households headed by persons older than 62 continued to have the lowest average rent of any age group ($436 per month) but the highest average share of income paid in rent (33.5%). Households with the longest tenure in their units had the lowest average rent ($439), while those who had moved within the last year had the highest ($601), and the gap between these averages continued to grow. Two-person households paid the highest average rent ($560), but households of five persons or more had the highest rent-to-income ratio (34.7%). Households with more than $40,000 in annual income paid the highest average rent ($666), but the lowest average share of income (15.4%), and the situation was reversed for households earning less than $10,000 per year.

Despite the general similarity of the 1987 pattern of rent-to-income ratios to that of 1984, some noticeable changes did occur among demographic subgroups:

* The average share of income paid in rent by households headed by a person older than 62 held steady (at a high level), while the share paid by the other age groups increased.

* The average share paid by single-member households fell slightly, while the share paid by households of all other sizes increased. Most of the growth in average ratios was in households of three or more persons.

* The average share paid by households with more than $40,000 in annual income held steady, while the share paid by all other income groups increased. The average share paid by households earning less than $10,000 soared to 58% of income.

* The average share paid by households headed by Whites declined slightly and that paid by Black-headed households declined more substantially, while the average share paid by households headed by Hispanics and other minority group members increased sharply.

In the unstabilized household population, for which data were gathered only in 1987, average gross rent was found to be $675 per month, or 19% more than the average in stabilized units. The average rent-to-income ratio in the unstabilized households was 30.6%, as compared to the 29.2% average in the stabilized population. Only unstabilized households with an income of more than $30,000 per year reported an average rent-to-income ratio under the Federal affordability standard of 30%.

Rent Stabilization Benefits to Tenants

While difficult to measure with precision, the overall average dollar savings to tenants resulting from rent stabilization were estimated to rise from $18 per month in 1984 to $24 per month in 1987. This was the estimated differential between actual rents paid and the rents that would have been paid if rent stabilization had never been adopted. The overall average masked great differences between tenants of different types, particularly as to length of tenure in their units. The data indicated no savings at all for households that had moved within the past three years, whereas those which had been in their units since rent stabilization began were estimated to be saving $94 per month, or about 5% of their income.

The fact that overall average savings continued to increase was wholly attributable to the City Council's 1985 replacement of the flat 7% ceiling on rent increases with the CPI-based ceiling-setting formula. The flat ceiling would have permitted stabilized rents to rise as fast as the market did, whereas the CPI-based formula held the increase in stabilized rents about one-third lower than the average increase in the unregulated rents charged to new tenants. Analysis of the data indicated that by 1987 the Rent Stabilization Ordinance was keeping the rent paid by about 43,000 households (or 9% of all stabilized households) under the Federal affordability limit of 30% of income which would otherwise be above that limit.

The distribution of rent stabilization benefits among demographic groups was generally similar in 1987 to the pattern in 1984. In both years, households at the high end of the benefit scale tended to be:

* Middle aged to elderly (virtually all headed by persons over 30, and more than one-third by persons over 62).

* Low to moderate income (two-thirds under $30,000 per year and one-seventh under $10,000).

* Small in size (nearly three-quarters composed of no more than two persons, and nearly half of one person).

* Headed by Whites (who accounted for about three-fifths of the long staying households which reaped the highest benefits from rent stabilization).

* Concentrated in the Hollywood-Wilshire Labor Market Planning Area (which housed about half of the long stayers, while no other LMPA contained as many as one-fifth).

The 1987 data indicated that the average income of the longest staying households, the prime beneficiaries of rent stabilization, grew very little in the preceding three years ($662 per year, as against an average increase of $2,700 in all rent stabilized households), and that they suffered an average loss of real income of about 9% during that period.

At the other end of the scale, households that received little or no benefit from rent stabilization, and in some instances paid premiums above market rents, tended to be:

* Young to middle-aged (nearly half headed by persons under 30 and virtually none by persons over 62).

* Moderate income (nearly two-thirds under $30,000, but not many under $10,000).

* Small to medium in size (about two-thirds comprised of two persons or fewer).

* Nearly equally divided between White and non-White household heads (Whites accounted for just over half).

* Less concentrated geographically (no LMPA accounted for as many as half and the plurality was shifting rapidly from the Hollywood-Wilshire Area to the Valley).

The total dollar savings from rent stabilization for all stabilized households was estimated at $137.6 million in 1987, a 29% increase from the $106.9 million estimated for 1984. Despite the fact that households headed by elderly persons received the highest average savings, the fact that there were so many more

non-elderly households in the stabilized population meant that more than 60% of the savings benefits of stabilization were realized by households whose heads were not elderly.

As in 1984, the 1987 survey found that tenants' own estimates of the savings they realize because of rent stabilization was far higher than the statistics indicate. The difference between the rent that tenants who knew their rents were stabilized actually paid and the amount that they estimated they would pay without stabilization suggested a savings volume about five times as high as the statistically-based estimate.

Situation of Building Owners

No existing data base is perfectly representative of Los Angeles landlords. However, data from two sources, the Institute for Real Estate Management (IREM) and the State Franchise Tax Board (FTB) provide a reasonable basis upon which to assess developments in building owner finances. Numbers are available for only one year -- 1986 -- after the Council changed the method of setting ceilings on rent increases, so that firm conclusions are not yet possible. However, the available data suggest that:

* Net operating income per unit derived from stabilized buildings rose by 8% in 1986 over 1985, a slower rate than the 10.5% that had been the average in the preceding two years, but it was not clear that this could be traced to the change in formula because net income in a sample that included unstabilized buildings also showed a drop in 1986.

* Because of a sharp increase in average financing costs, the increase in net operating income did not translate into an increase in before tax cash flow, which actually dropped slightly (3%) in 1986.

* Larger buildings (12 units and more) maintained their average rental income growth in 1986 at the level of prior years (about 11% per year), while smaller ones sustained a reduction (from 11% to 6%) in 1986. However, larger buildings also tended toward larger increases in expenses, so that the smaller ones had bigger percentage gains in net income.

* Average net operating income per unit rose in all areas of the City except the Northeast LMPA in 1986.

Thus, although expenses increased relative to rental income in 1986, this was true of both the stabilized stock and the total rental stock in the City, and it did not stop average net operating income per unit from increasing. Although the investment and capital appreciation data necessary to make an overall assessment of the change in landlord financial circumstances are not available, the operating data did not indicate any major shifts toward unprofitability during the period since introduction of the new ceiling-setting formula.

The special analysis of the impact on landlord finances of recent increases in liability insurance costs confirmed that these increases have enlarged the share of building expenses that they comprise. However, while this increase was large in terms of prior insurance rates, it still made up a relatively small share of total building expenses. Moreover, the available data indicate that contrary behavior in other expense items has offset the increase in insurance costs, keeping it from being expressed either in higher total operating expenses or in lower net operating income.

Maintenance and Reinvestment in the Stabilized Housing Stock

The 1987 survey of tenant perceptions of the quality of maintenance of the stabilized stock indicated that tenants viewed maintenance as stable and perhaps improving slightly. Nearly 80% of the respondents reported satisfaction with the physical condition and upkeep of their housing, a proportion almost identical to the 1984 response. On the other hand, nearly one-third of the respondents indicated dissatisfaction with the speed of repair and almost as many reported dissatisfaction with their landlords, a higher level of dissatisfaction than was recorded in 1984. When these responses were analyzed, it became clear that dissatisfaction tended to be statistically correlated with length of tenure -- the longer the tenure, the higher the probability of dissatisfaction with housing quality and the landlord.

Review of the available data on landlord expenditures for maintenance and repair indicates that this spending was rising at a lower rate than total operating expenses in 1987, but that this was true in both the stabilized and the unstabilized stock.

Review of the information available with respect to reinvestment in the stabilized stock suggests that the share of it that flows through the City's capital improvement program (which permits a rent increase based on amortization of the cost of the improvement) continued at a relatively constant rate. However, an estimate of the normal needs of multi-family buildings indicated that the great bulk of this reinvestment was occurring without application of the building owner for a rent increase, and was thus financed through ordinary rental income including increases allowed within the normal rent stabilization rules.

Overall, the evidence on maintenance and reinvestment gave no cause for altering the conclusion of the earlier study that rent stabilization has had little if any effect on housing maintenance or reinvestment in Los Angeles.

The Problem of "Historically Low Rents"

This problem is argued to exist in smaller buildings with high concentrations of long staying tenants who were assertedly being charged below-market rents at the time that rent regulation was introduced. The owners of these buildings are alleged to

have failed to take advantage of the onetime rent increase of 13-19% that was permitted to landlords who had not raised their tenants' rents within the 12-24 months preceding the introduction of controls. Thus, it is argued, the rents paid by these households have never been brought to market levels, and the buildings in which they are concentrated are so unprofitable as to threaten maintenance and reinvestment, and thereby reduced housing quality. Moreover, the argument concludes, many of the payers of these substandard rents fall into the category which the earlier study called "unintended beneficiaries" of rent stabilization, i.e., households with annual incomes of more than $40,000 which were not headed by an elderly person.

When the argument was dissected into five factual propositions which can be tested by the available empirical evidence from the general data base of the study, the following findings emerged:

* Even if one accepts the questionable assertion that a rent arising from an unregulated market and subject to a onetime correction to remedy timing anomalies is still a below-market rent, the data provided no evidence of systematic charging of such pre-stabilization rents to households that have stayed in place throughout the stabilization period.

* The data did suggest a slightly higher rate of tenant turnover in larger buildings as against smaller ones, but not a difference that suggests a systematic concentration of long staying households such as to create a widespread problem of historically low rents.

* There was no evidence of a systematic differential in level of financial performance as between larger buildings and smaller ones.

* The evidence indicated no systematic difference between larger and smaller buildings with respect to maintenance problems. Though there were some indications that smaller buildings provided lower average housing quality by some measures, these differences disappeared when the analysis controlled for the differential in building age.

* There was no evidence of systematic difference in the average age of household head or the average household income in large vs. small buildings, as might be expected if there were unusual concentrations of "unintended beneficiaries" of rent stabilization in smaller buildings.

Thus, the general data base provided no reason to believe that a problem of this type existed on any substantial scale.

Nevertheless, in order to test to see whether the overall averages were masking the problem, three associations of building owners were asked to designate a special sample of buildings

where the problem was alleged to exist. A special survey of tenants in units in this sample (93 buildings, 881 units) was conducted. It revealed that:

* No long staying households (i.e., ones that had been present since the advent of rent stabilization) at all were discovered in half of the buildings whose tenants could be contacted.

* Only 23% of these buildings contained respondents more than half of whom were long stayers.

* No more than 16% of the buildings containing respondents to the survey could possibly have been filled to capacity by long staying households.

In addition, face-to-face interviews were held with all or most of the tenants in 11 of the buildings in the special sample. These interviews established that none of these buildings was entirely filled with long stayers, only 18% of them were more than 50% filled with long stayers, and that 27% of them had no long stayers at all.

In sum, no empirical evidence of a historically low rents problem of any dimension was found. Although isolated instances of such concentrations may exist in some buildings, it seems quite unlikely that they are of sufficient number or intensity to threaten any appreciable long-term deterioration of the stabilized stock.

Consultants' Policy Recommendations

The City asked for the consultants' policy views as one of many inputs that the Council will take into account in its deliberations with respect to the Ordinance. These recommendations, which are necessarily subjective in nature, are as follows:

* The current CPI-based formula for setting ceilings on rent increases in the stabilized stock should be retained, together with the other rules and principles that make up the current Los Angeles rent stabilization regime. The ceiling has worked demonstrably better than the prior flat ceiling, and its flexibility may be even more important in the future economic climate than it has been in that of the past three years.

* No general exception should be made for concentrations of historically low rents. However, a non-retroactive adjustment of the size originally provided in the provision of the Ordinance designed to remedy timing anomalies should be granted to landlords who can show that (i) although entitled to it, they did not take advantage of the onetime adjustment at the beginning of rent regulation; (ii) the tenant in the subject unit has not vacated the unit during entire life of the stabilization program; (iii) the tenant has been charged

the maximum allowable rent increase in every year of that period; and (iv) at least half the units in the building have experienced the same phenomenon. If granted, this adjustment should be phased in over three years so as not to inflict undue hardship on the tenant.

* No change should be made in the current rules dealing with capital improvements.

* Though the massive average share of income paid in rent by households with annual incomes of less than $10,000 is a matter of rightful policy concern, the City should not attempt to deal with the basic problems of poverty by manipulating the rent stabilization rules. To attempt to do so would disrupt the delicate balance between tenant protection and landlord maintenance and reinvestment incentives that the Ordinance is designed to achieve.

* The factors most deserving of more careful monitoring than is already the case are (i) the behavior of housing density (i.e., number of persons per room); and (ii) the rate of new construction, which is probably now out of the boom stage and is unlikely to provide the market outlet that it has during the past three years.

* So long as the City elects to maintain a rent stabilization regime of the current general design, reviews of the impact of the Ordinance should be conducted at intervals of not less than three or more than five years. In preparation for the next one, three data/analysis problems deserve special and in some cases immediate attention:

  # Development of a data base on landlord finances that is more representative of owners of stabilized buildings of all types within the City of Los Angeles than are any of the existing sources of data.

  # Development of a more textured standard against which to measure the benefits of rent stabilization.

  # Expansion and continuation of the gathering of information on the unstabilized stock, which is necessary to make a rounded assessment of events in stabilized rental housing.

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